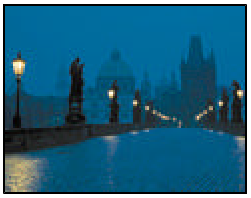

FINANCE & DEVELOPMENT
A quarterly magazine of the IMF
September 2000, Volume 37, Number 3

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Central Asia: Achievements and Prospects

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Although the five Central Asian countries in transition have made progress in moving to a market economy, they still have far to go and need to intensify their reform efforts.

At the beginning of the 1990s, following a long period of isolation, the Central Asian states of the former Soviet Union—Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan—faced the tough challenge of achieving a market framework, integrating their economies with the rest of the world, and improving living standards. Since then, all five countries have made progress toward decentralizing their economies, expanding international links, and diversifying and increasing production and trade. Comparisons with other transforming economies, however, indicate that much more remains to be done (Table 1). In most of these countries, the private sector's share still constitutes less than one-half of economic activity; banking systems continue to be heavily state controlled; and per capita foreign direct investment remains relatively low. A set of indicators developed by the European Bank for Reconstruction and Development (EBRD) to measure progress in privatization, enterprise restructuring, and price, trade, and financial sector reforms indicate that this group of transition countries lags behind most of the others.

Table 1
Selected indicators, 1998-99

	Population (millions)	**GDP per capita** (dollars)	**Private sector** (percent of GDP)	**Foreign trade** (percent of GDP)	**Foreign direct investment per capita** (dollars)	**EBRD transition indicators** (1998)[1]

Central Asian countries	56.2	603	45	37	23	2
Kazakhstan	17.2	965	55	28	67	3-
Kyrgyz Republic	4.7	380	70	37	22	3
Tajikistan	6.1	344	30	54	4	2
Turkmenistan	4.4	654	25	47	14	1+
Uzbekistan[2]	23.9	673	45	20	7	2
Russia	146.8	1,258	70	24	19	2+
Other Commonwealth of Independent States	81.5	754	51	37	48	2+
Baltics	7.8	3,067	68	49	158	3
Central and Eastern Europe	112.7	3,602	67	39	111	3

Sources: National authorities, IMF staff estimates; and European Bank for Reconstruction and Development (EBRD), *Transition Report*, 1999.

Note: Other than for population, the group entries represent unweighted averages for the countries in the groups.

[1] Average of EBRD transition indicators covering enterprise, financial sector, legal, and market and trade reform. Individual indicators range from 1 to 4 +, with 1 representing no or little change from the previous regime and 4 + indicating the most progress in reforms as measured against the standards of industrial market economies.

[2] GDP per capita is calculated using the official exchange rate. If the indicative exchange rate (a weighted average of the official, commercial bank, and curb market rates) were used, GDP per capita would be $326.

Policies and structural reforms

The pace and intensity of reform have varied widely across the five Central Asian transition countries, influenced partly by differences in natural resource endowments, economic structures, and sociocultural factors. The two fastest reformers—Kazakhstan and the Kyrgyz Republic—started out at opposite ends of the spectrum, in many respects, with the former having a much richer resource base and a more diversified economic structure. Kazakhstan was quick to take advantage of its initial relative strengths, while the Kyrgyz Republic strove to overcome its initial limitations. By contrast, economic reforms in Turkmenistan and Uzbekistan—which fall somewhere in the middle on the resource and output diversity spectrums—were more sporadic and came in reaction to, rather than in anticipation of, events. In Tajikistan, reforms were initially constrained by civil conflict but have finally begun to move forward.

The early years of transition were characterized by sharp output declines and an erosion of living standards in all five countries (Table 2). In addition to the severe disruptions to input supplies and traditional lines of production associated with transition, special circumstances, such as civil unrest (Tajikistan) and reliance on traditional trade routes and regional energy pipelines (Kazakhstan and Turkmenistan), constrained export markets and output growth. The negative impact of structural dislocations on growth was aggravated by high inflation resulting from price liberalization and the monetization of large fiscal deficits. By the same token, the rapid reduction of inflation and the depth of structural reforms were instrumental in bringing about strong, durable recoveries in 1996-99. Successful adjustment helped boost confidence and attract foreign direct investment (especially in Kazakhstan), which buttressed economic recovery.

A substantial decline in real wages was partly offset by generous consumer subsidies and income from informal market activity. Developments in employment and wages were also influenced by the degree to which countries were willing to restructure their state enterprise sectors. Restructuring entailed imposing hard budget constraints, notably phasing out budgetary support and directed credits to enterprises, which led to higher unemployment. In Turkmenistan, Tajikistan, and Uzbekistan, where this process was delayed, open unemployment rates remained low.

Given the loss of transfers from the Soviet budget, a lack of domestic financing from nonbank sources, an inability to fully benefit from energy terms of trade gains because of a shortage of pipelines (this was particularly a problem for Turkmenistan), and limited access to international capital markets, the Central Asian transition countries had little choice but to implement major fiscal structural reforms to meet their stabilization objectives. However, fiscal imbalances were reduced primarily by stopgap measures. The countries relied heavily on expenditure sequestration and ad hoc revenue measures—particularly in the initial years of transition—and governments and state enterprises were far too tolerant of payment arrears. Moreover, large quasi-fiscal operations conducted outside the budget, mainly by the banking sector, weakened fiscal transparency and management. The adjustments that took place, therefore, represented only the first phase of a more substantive fiscal reform process, aimed at substantially rebuilding revenue and reprioritizing expenditure.

Following the introduction of their national currencies in 1993-95, the Central Asian transition countries intensified efforts to sharply lower inflation from peak rates in the four digits. They had to choose between exchange rate and money-based stabilization programs. The two main arguments for an exchange rate peg—the instability of money demand during the turbulent transition period and the likelihood of exchange rate overshooting with money-based stabilization—were valid, but these countries failed to meet the conditions required for a successful peg (restrained fiscal policies and ample international reserves). Moreover, with a peg, real shocks (such as sharp terms of trade shocks) could not be absorbed. Therefore, all five countries initially opted for money-based stabilization programs, with limited exchange rate flexibility. The burden of stabilization fell primarily on fiscal adjustment, which entailed cutting expenditures (particularly real wages, subsidies, and capital outlays) and tightening budget constraints on state enterprises. Kazakhstan and the Kyrgyz Republic focused on state enterprise restructuring early and eliminated directed credits, but the other three countries moved much more slowly in this area.

All five countries reduced inflation dramatically; currencies were stabilized—some even appreciated in real terms; and parallel market premiums were reduced (except in Uzbekistan, until very recently, and Turkmenistan). These moves were accompanied by the liberalization of exchange regimes at various speeds, with the faster reformers taking the lead. As stabilization took hold, Kazakhstan had to protect its economy from the destabilizing effects of surges in capital inflows, which entailed striking an appropriate balance between fiscal tightening, sterilized interventions, and currency appreciation. The rest of the group, however, has yet to face such challenges.

Table 2
Selected macroeconomic indicators

	1992	1993	1994	1995	1996	1997	1998	1999 (provi - sional)
Kazakhstan								
Inflation (end of period; percent)	2962.8	2169.1	1160.3	60.4	28.6	11.3	1.9	18.1
Real GDP (percent change)	-5.3	-9.2	-12.6	-8.2	0.5	1.7	-1.9	1.7
Fiscal deficit (percent of GDP)	-7.3	-4.1	-7.7	-3.2	-5.3	-7.0	-7.7	-5.2

Current account balance (percent of GDP)	-51.4	-9.4	-8.6	-3.1	-3.6	-3.5	-5.5	-1.0
Gross official reserves (months of imports)	0.2	1.3	2.6	2.7	3.1	3.6	3.1	3.6
External debt (percent of GDP)	40.1	35.7	23.9	20.7	18.7	32.2	36.0	44.5
Kyrgyz Republic								
Inflation (end of period; percent)	1257.0	766.9	95.7	32.3	34.8	14.7	18.4	39.9
Real GDP (percent change)	-13.9	-15.5	-20.1	-5.4	7.1	9.9	2.3	3.6
Fiscal deficit (percent of GDP)	-17.0	-14.4	-11.6	-17.3	-9.5	-9.0	-10.0	-12.6
Current account balance (percent of GDP)	-10.6	-16.4	-11.2	-16.3	-23.5	-7.9	-19.8	-13.6
Gross official reserves (months of imports)	0.8	1.5	2.6	2.5	1.7	3.6	2.3	2.7
External debt (percent of GDP)	0.6	43.7	37.4	39.1	41.5	56.2	72.3	108.1
Tajikistan								
Inflation (end of period; percent)	...	7343.7	1.1	2133.3	40.5	163.6	2.7	31.3
Real GDP (percent change)	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7
Fiscal deficit (percent of GDP)	-30.5	-23.4	-5.4	-11.9	-5.8	-3.3	-3.8	-3.1
Current account balance (percent of GDP)	-18.0	-29.5	-19.7	-16.2	-7.3	-6.0	-9.3	-3.7
Gross official reserves (months of imports)	0.0	0.4	0.0	0.1	0.3	0.6	1.5	1.7
External debt (percent of GDP)	74.5	77.0	93.6	142.1	91.7	108.7	92.6	103.3
Turkmenistan								
Inflation (end of period; percent)	664.0	1400.0	1328.5	1261.5	445.9	21.5	19.8	20.1
Real GDP (percent change)	-5.3	-10.2	-19.0	-8.2	-7.7	-11.3	5.0	16.0
Fiscal deficit (percent of GDP)[1]	13.0	0.0	-1.0	-2.0	0.0	0.0	-2.7	0.9
Current account balance (percent of GDP)	54.7	20.1	1.8	1.3	2.1	-21.6	-32.7	-16.0
Gross official reserves (months of imports)	0.0	6.2	6.6	8.5	9.2	15.3	14.6	13.7
External debt (percent of GDP)	0.0	3.1	9.0	29.7	28.1	50.6	61.1	53.9
Uzbekistan								
Inflation (end of period; percent)	910.0	884.8	1281.4	116.9	64.4	50.2	26.1	26.0
Real GDP (percent change)	-11.0	-2.3	-4.2	-0.9	1.6	2.4	4.4	4.4
Fiscal deficit (percent of GDP)	-18.0	-10.0	-6.1	-4.1	-7.3	-2.2	-3.3	-3.0
Current account balance (percent of GDP)	-11.7	-7.8	2.1	-0.2	-7.2	-4.0	-0.8	-1.0
Gross official reserves (months of imports)	0.6	3.8	5.9	6.9	5.4	3.7	4.8	5.7
External debt (percent of GDP)	1.7	18.9	17.0	17.5	17.5	17.9	23.9	26.7

Sources: National authorities; and IMF staff estimates.

[1] Extrabudgetary funds not included.

... Not available.

The financial crisis in Russia in August 1998 considerably altered the external economic environment for the Central Asian transition countries. Russian demand for their exports dropped sharply. Capital flows were also affected, as foreign investors reassessed the risks in the region, and exchange rates came under pressure. The five countries were faced with resisting a reversal in exchange and trade liberalization. Turkmenistan and Uzbekistan initially intensified exchange controls, while the other three countries combined financial restraint with exchange market intervention to ward off the pressures on their economies. Nevertheless, the currencies of Kazakhstan, the Kyrgyz Republic, and Tajikistan depreciated sharply, in nominal terms, by the end of 1998 and into 1999. Inflation flared up again. These events underscored the need to strengthen external debt management, following years of heavy borrowing, to compensate for low domestic saving rates and sustain investment. The countries should continue to take a cautious approach to external borrowing—even Kazakhstan, which has gained the favor of international markets (particularly since oil was discovered there) and recently repaid its IMF loan, well ahead of schedule.

Progress with structural reforms has been mixed. All five countries were relatively quick to initiate price liberalization, although each has proceeded at a different pace, and there have been temporary reversals, primarily to avert social unrest. In almost all cases, controlled prices were maintained for essential foodstuffs, energy, public transportation, and utilities. State enterprise restructuring proved particularly difficult, given the magnitude of the task and the reluctance of authorities to disrupt production and the provision of social services by enterprises. Considerable progress was made in Kazakhstan and the Kyrgyz Republic in initiating restructuring programs and in building the needed institutional frameworks. All countries experienced large domestic payment arrears in their state enterprise sectors, which partly mirrored the phasing out of traditional sources of finance (particularly directed credits) to this still dominant sector.

Privatization proved to be particularly daunting, although the faster reformers progressed considerably beyond the first stage of small enterprise privatization to mass privatization of medium- and large-scale enterprises. The ground was also laid for the privatization of agriculture through land-lease programs and the phasing out of state orders, although privatization of agricultural services fell behind. Legal and regulatory reforms, on the other hand, proceeded in piecemeal fashion, with only Kazakhstan and the Kyrgyz Republic undertaking more in-depth reforms of their civil codes.

Future challenges

The slowest reformers in this group—Turkmenistan and Uzbekistan—will need to switch from crisis management to policies designed to contain macroeconomic imbalances and prepare the ground for sustainable growth. Such a shift requires the formulation and determined implementation of comprehensive and internally consistent economic stabilization and reform programs. Tajikistan has already initiated this process. For Kazakhstan and the Kyrgyz Republic, the major challenge will be to deepen, and build upon, the structural changes introduced so far, while taking care not to reignite inflation and balance of payments pressures by easing fiscal and monetary policies too much, too soon. In all five countries, successful adjustment requires government ownership of reforms as well as endorsement of reforms by influential groups outside the government.

Further action is needed in five key areas: enhancing the quality of fiscal adjustment; strengthening financial intermediation and financial institutions; improving external debt management; increasing the depth and scope of structural reforms; and addressing governance and corruption issues.

The brunt of fiscal adjustment in the Central Asian transition countries has been borne by expenditure cuts and payment arrears, with insufficient attention paid to the level and quality of government expenditure on social services (notably health and education), basic infrastructure, and operations and maintenance. Efforts to raise revenue have been thwarted by tax administrations that are ill equipped to enforce tax collection, the prevalence of domestic payment arrears (including by governments), and flourishing underground economies that largely escape taxation. Future efforts will need to be directed at raising revenue collections substantially and better prioritizing of spending. To avoid the recurrence of payment arrears and dismantle a widespread system of mutually offsetting expenditure and tax arrears, these countries will need to undertake civil service reforms, curtail nonproductive spending, and adopt public investment programs. Also, as reforms take hold and economic distortions disappear, underground economies can be expected to shrink.

Notwithstanding some cross-country differences, the banking systems of the Central Asian transition countries are still at a fairly rudimentary stage of development. A few large state banks continue to account for the bulk of transactions, acting more like state agents than like independent financial intermediaries. An important task for these countries will be to restructure their banking systems with a view toward strengthening monetary policy and supporting the economic recovery. Action in this area will also be needed to safeguard against protracted structural lending to bail out failing banks and enterprises, arrest currency substitution, and promote an efficient and solvent banking system. Such action will entail improving the legal and accounting frameworks, adopting effective prudential regulations, and strengthening bank supervision.

External borrowing by the Central Asian transition countries has grown rapidly, primarily to finance budget deficits, meet growing import bills, and benefit from cheaper sources of finance. For the most part, borrowing strategies were based on short-term considerations, with insufficient attention to debt sustainability in the medium term. Accordingly, the funds borrowed were not always channeled to uses that would generate the earnings needed to service them. The institutional arrangements for managing and monitoring the external debt were generally weak. To avoid debt-servicing difficulties and disruptions to reforms, these countries will need to keep their borrowing strategies under close review, formulate such strategies within a medium-term framework, and strengthen the institutional arrangements for external debt management and monitoring.

While all five Central Asian transition countries have begun implementing structural reforms, the depth and determination with which they have been undertaken vary considerably. The slower reformers need to give priority to catching up in such key areas as privatization and enterprise restructuring. For countries that have made substantial progress in these areas, the next stage might be to reform labor markets, the civil service, and the trade and regulatory systems, while pursuing sectoral (notably agrarian) reforms. At the same time, to bolster the confidence of private savers and investors, state intervention must be limited, essentially to the provision of reliable public services, establishing a simple and transparent regulatory framework, and enforcing a fair judicial system.

Finally, firmly tackling governance and corruption will be an important challenge for the Central Asian transition countries. There is considerable evidence that corruption is associated with lower investment, slower economic growth, concentration of government spending on less productive activities, and a greater incidence of income inequality and poverty. The most effective way to strengthen governance and fight corruption is to implement structural, institutional, and legal reforms. Such reforms, by better balancing the roles of the state and the market and clearly establishing the rule of law, can eliminate some of the conditions that breed corruption and help restore confidence, which is essential to promoting private sector activity and attracting foreign capital to the Central Asian transition countries.

This article is based on Emine Gürgen and others, 1999, Economic Reforms in Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan*, IMF Occasional Paper No. 183 (Washington: International Monetary Fund).*

Emine Gürgen was Assistant to the Director of the IMF's European II Department at the time this article was written.